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Request for Technical Assistance--Revolving credit sales

This is in response to your request for technical assistance, dated February 27, 1991, concerning the repeal of the use of the installment method to report income from the disposition of personal property under a revolving credit plan. Specifically, you request a clarification on section 1008(g)(6) of the Technical and Miscellaneous Revenue Act of 1988 (the "TAMRA")(hereinafter referred to as the "Contraction Rule"), which as further explained below allows for an acceleration of the section 481(a) adjustment that is taken into account as a result of the above mentioned repeal.

Under sections 453A(a)(1) of the Internal Revenue Code of 1954 (the "1954 Code") and 1.453A-2(a) of the Income Tax Regulations, a dealer that sells or otherwise disposes of personal property under a revolving credit plan may report such sales on the installment method.[1] Section 1.453A-2(c)(1) provides, in part, that the term "revolving credit plan" includes cycle budget accounts, flexible budget accounts, continuous budget accounts, and other similar plans or arrangements for the sale of personal property under which the customer agrees to pay each billing-month a part of the outstanding balance of the customer's account.

[1] Section 453A(a)(1) of the 1954 Code gives the Secretary authority to prescribe regulations that allow a dealer to report certain sales under the installment method. Pursuant to this authority, sections 1.453A-1 and -2 of the regulations were published to provide rules for revolving credit plans. Although these sections were published on November 2, 1989, after the years at issue, these sections generally are applied retroactively to tax years beginning on or before December 31, 1986. See, sections 1.453A-1(h) and -2(d).

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Paragraph (a) of section 812 of the Tax Reform Act of 1986 (the "TRA") added section 453(k)(1) to the Internal Revenue Code of 1986 (the "Code"), which provides, in part, that a disposition of personal property under a revolving credit plan is treated as an installment sale with respect to which all payments are received in the year of sale.[2] See, also, H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-293, 299 (1986). Paragraph (c)(1) provides that paragraph (a) applies to tax years beginning after December 31, 1986. Paragraph (c)(2)(C), as originally enacted, provides in part that the period for taking into account adjustments under section 481 by reason of a change in method of accounting to comply with paragraph (a) shall not exceed 4 years.

In relevant part, sections 1008(g)(5) and (6) of the TAMRA amended section 812(c) of the TRA in three regards. First, paragraph (c)(2)(C) was rewritten so that the provision now provides that the period for taking into account adjustments under section 481 of the Code by reason of a change in method of accounting to comply with paragraph (a) shall equal 4 years. Second, a new paragraph (c)(2)(D) was added which provides that, except as provided in paragraph (c)(4), the amount taken into account in each of such 4 years shall be the applicable percentage of the 481 adjustment, and the applicable percentage for the four years shall equal 15%, 25%, 30%, and 30%, respectively. Third, the Contraction Rule was added in new paragraph (c)(4), providing rules that increase these four applicable percentages in certain situations.

The Contraction Rule generally requires a taxpayer to (1) determine its aggregate contraction in revolving installment obligations, (2) divide this aggregate contraction by the aggregate face amount of revolving installment obligations outstanding at the close of the taxpayer's last taxable year beginning before January 1, 1987, and (3) subtract this balance from the sum of the applicable percentages for the years up to (but not including) the taxable year involved (i.e., 0% in year 1, 15% in year 2, 40% in year 3, etc.). If this amount is greater than the applicable percentage for that year, this amount is substituted for the applicable percentage for that year. See, section (c)(4)(A) and (B), as added by section 1008(g)(6) of the TAMRA.

[2]When added to the Code, section 453(k) of the Code incorrectly appeared as section 453(j). Section 1008(g)(1) of the TAMRA corrected this mistake by redesignating the provision as section 453(k).

For these purposes, the aggregate contraction equals (1) the aggregate face amount of the revolving installment obligations outstanding at the close of the taxpayer's last taxable year beginning before January 1, 1987, less (2) the aggregate face amount of the revolving installment obligations outstanding at the close of the taxable year involved. See, section (c)(4)(C). Further, the term "revolving installment obligations" means installment obligations arising under a revolving credit plan as defined in section 1.453-2(d) of the regulations. See, section (c)(4)(D) and S. Rep. No. 313, 99th Cong., 2d Sess. 122, 130 (1986).

For example, assume that X is a calendar year taxpayer that was using the installment method to report income from the disposition of personal property under a revolving credit plan, and, pursuant to the TRA, X changes to the accrual method in 1987. Assume further that on December 31, 1986, the aggregate face amount of X's outstanding revolving installment obligations equals $100, and X has a basis in these obligations equal to $20. With respect to these obligations, X has a section 481 adjustment equal to $80. Thus, as a general rule, X must recognize $12 of this $80 adjustment in 1987 (15% x $80). However, if in 1987, X were to collect $80 on these obligations and sell $40 of personal property under a revolving credit plan (none of which is collected in 1987), X's percentage determined under the Contraction Rule would be 40% ([100 - (100 - 80 + 40)]]/100). Accordingly, X would be required to recognize $32 of this $80 adjustment in 1987 (40% x $100).

As illustrated by this example, the Contraction Rule looks to the year-end balance of installment obligations arising from dispositions of personal property under a revolving credit plan, without regard to when the obligation arose. A sale of personal property under a revolving credit plan is treated as an installment sale although such a sale no longer qualifies for favorable installment method treatment (i.e., all payments with respect to the sale are deemed received in the year of sale). See, H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-293, 299 (1986). Thus, the year-end balances of these obligations must be taken into account for purposes of the Contraction Rule.

In allowing any deferred gain on revolving credit plan sales that were reported on the installment method to be recognized over 4 years, the Congress is trying to soften any impact due to this sudden change. (This desire is also displayed by noting that, instead of a prorata pickup of the section 481 adjustment, the applicable percentage begins at 15% and increases over time.) This rule generally helps the dealer that, after 1986, continues to sell personal property under a revolving credit plan and continues to collect amounts due on these obligations rather than cashing-out on them (e.g., by selling these obligations to a third party). In this case, the dealer has not yet collected the proceeds with which to pay tax on both its 1987 and pre-1987 deferred sales.

For example, assume that, in 1987, the dealer in the example above had collected $100 and sold $100 of personal property under a revolving credit plan (none of which was collected in 1987). Using the revolving credit plan receivables outstanding at the end of 1987 ($100), the dealer recognizes $100 of income on its 1987 sales and $15 of the section 481 adjustment. However, if the Contraction Rule applied because we use the balance of obligations outstanding at the end of 1986 that are also outstanding at the end of 1987, the dealer recognizes $100 of income on its 1987 sales and $100 of the section 481 adjustment. This result would be very harsh considering that the dealer has not yet collected any proceeds on the 1987 sales.

However, if this dealer were to collect $100 in 1987 and sell the $100 of installment obligations outstanding at the end of 1987, the dealer has the proceeds with which to pay any gain on the underlying sales. Thus, an anti-abuse provision is necessary to prevent a dealer from avoiding the purpose of the 4-year spread. The Contraction Rule, which is this anti-abuse provision, requires this dealer to recognize 100% of the section 481 adjustment.

If you have any further questions on this matter, please do not hesitate to contact James A. Orefice at (202) 535-6461.

cc: Robert Steinmetz, Retail Industry Specialist